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C O N F I D E N T I A L SECTION 01 OF 05 TEGUCIGALPA 001581

SIPDIS

STATE FOR WHA/CEN, WHA/ESPC, DRL/IL, EB/IFD/OMA
STATE PASS AID FOR LAC/CEN
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E.O. 12958: DECL: 07/02/2013
TAGS: EFIN ECON PGOV EAID ETRD ELAB HO EAGER
SUBJECT: IMF PROGRAM APPEARS IN REACH IF/IF GOH ADOPTS CIVIL SERVICE REFORM; IS USG PUSH POSSIBLE?

REF: A. (A) TEGUZ 865
¶B. (B) TEGUZ 1141
¶C. (C) TEGUZ 494
¶D. (D) TEGUZ 10

Classified By: AMBASSADOR L. PALMER FOR REASONS 1.5(B) AND (D)

Summary and Action Request

¶1. (C) For its entire year and a half in office, the Maduro administration has struggled to reach agreement with the IMF on a Poverty Reduction and Growth Facility (PRGF) program that will put Honduras back on a growth track and allow badly-needed permanent debt relief to resume. With the April adoption of a second tax package that should increase tax receipts by USD 300 million annually, the GOH made a major step toward an IMF agreement. World Bank and IDB approval of projects to strengthen the Honduran banking system is another important milestone. In the context of work on the banking sector, the GOH has issued a long analytical report on the new agricultural credit program laying out a persuasive case that the law limits and rationalizes (rather than expands) subsidies provided for agricultural financing. The most important requirement now for an IMF program is enactment of a Civil Service Framework Law that will put a brake on the unsustainable growth in the central government's wage bill. The IMF is urging measures that, as part of the creation of a professional civil service, would fold in the public sector teachers and medical workers into a single civil service pay structure. However, President Ricardo Maduro and his top political advisors fear that change to the special statutes governing teacher and doctor compensation will provoke a strong, adverse political reaction; the President has not yet approved the submission of the bill to Congress (where it would indeed face a stiff fight). In the meantime, Honduras' failure to reach an IMF agreement has ended the technical deferral of Paris Club debt service payments, once again putting overdue loan payments to the U.S. into active status. In late June, ExIm Bank took Honduras off-cover for public sector loans. Lack of payment on overdue U.S. Department of Defense Loans in mid July and early September could trigger Brooke Amendment sanctions. However, the GOH is not at liberty to pay only one official creditor under Paris Club rules.

¶2. (C) Action Request: Maduro badly needs reassurance that (1) the civil service reforms (and the ensuing political fight) are indispensable, (2) the international community will support him if he does take this move, and (3) that an IMF agreement would likely be forthcoming quickly after passage of the law even if all IMF targets for reduction of the public sector wage bill are not completely met. Given the importance of reaching an IMF agreement this summer, the critical nature of this long-awaited structural reform and the advances made in other areas, Post recommends a full court press by the Embassy and Washington agencies to provide this reassurance and urge that the Civil Service Framework Law (and the related elimination of the compensation provisions in the teachers and medical workers laws) be introduced to Congress immediately. End Summary and Action Request.

Projections Show that Second Tax Bill Will Deliver Promised Revenue Increases

¶3. (C) As reported in ref A, on April 2, the Honduran Congress adopted a second fiscal package (the first was adopted in May 2002) designed to broaden the tax base, help reduce chronic budget deficits and move the government on the road to an IMF agreement. Congress modified some politically difficult provisions in the government-proposal but increased taxes on tobacco and alcohol in order to replace the foregone income. The target had been an annual

increase of 3.5 billion lempiras (USD 202 million) - of which about 2 billion lempiras (USD 116 million) would be collected in the remaining months of 2003, but at the time of passage IMF staff were skeptical that these targets would be met by the revised bill.

¶4. (C) Current GOH projections show that in fact the second tax bill should almost exactly meet its targets. Tax revenue in 2003 is projected to rise from the baseline level of USD 1.1 billion (16. 0 percent of GDP) to the current 2003 projection of USD 1.23 billion (17.5 percent of GDP) and then to USD 1.43 billion in 2004 (18.6 percent of GDP).

¶5. (C) Combined with earlier austerity measures taken in 2002 and 2003, the tax reforms should bring the central government's fiscal deficit down from 5.6 percent in 2002 to an estimated 3.5 percent of GDP in 2003, as predicted.

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Civil Service Law and Modification of Estatutos Still Key Sticking Point
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¶6. (C) The most problematic issue remains: getting public sector wages under control. The IMF mission has emphasized repeatedly the importance of enactment of a new civil service framework law that will provide the GOH with control over wage policy for all central government workers by superseding the salary provisions in the profession-specific laws (called estatutos) that were adopted in the mid-1980s. The Fund has also urged the GOH to reduce the central government wage bill from 10.7 percent to 10.1 percent of GDP in 2003 and reduce the wage bill of the entire public sector by one percent of GDP annually in 2004 and 2005.

¶7. (C) Enactment of civil service reform was a key (unfulfilled) condition in the previous three-year PRGF agreement with the IMF, and has taken center stage in the negotiations that have been going on between the Fund and the GOH since early 2002. Under the current regime, doctors and teachers have received high salary increases each year while non-unionized public sector workers have seen their salaries frozen. The salary provisions in the teacher "estatuto" are particularly complex, with the various provisions on salary and benefits resulting in compensation increases at rates far above inflation. This issue took on added saliency in July 2002 when the GOH reached an agreement with the majority of teachers to provide a 44 percent salary increase over four years (2002-2005), without affecting the concomitant increase in the benefits (called colaterales). Among other aspects that rankled the IMF staff to no end, this agreement provided the teachers with two separate wage increases in
¶2005.

¶8. (C) As seen in previous Embassy reporting, the Maduro Administration has been promising to introduce the civil service bill for many months, but kept breaking that promise. Behind the scenes, an intense debate was occurring over the extent to which teacher, doctor and nurse compensation would be covered by the new civil service rules. The GOH wanted to include only the basic salary, while the IMF was adamant that all salary and benefits provisions in the "estatutos" would need to be eliminated if the law was to have its intended effect of reining in the growth of the wage bill. The Fund staff also pushed for elimination of one of the scheduled teacher raises in 2005. At the same time, the GOH was negotiating with the doctors to accept the revised pay structure. Although doctor and nurse salaries comprise only a small percentage of the government wage bill, their salary demands are so obviously out of line with regional norms that the GOH hoped they could be pressured (or shamed) into an agreement. This strategy was not successful and the GOH has suspended negotiations for now.

¶9. (C) Post understands that the IMF and the Finance Ministry have now worked out language for the Civil Service law that would eliminate all salary provisions in the teacher and medical worker statutes except for the hardship locality differential (called the zonaje) and the June and Christmas bonuses. Teachers would be covered by the new law starting in June 2005 (allowing the government to avoid that second pay increase for 2005). The law would call for establishment of civil service grades and pay scales within six months of enactment of the law. Those government employees whose current salary exceeds the pay scale of their new civil service grade would forego future raises until such time as their salary was no longer above the cap.

¶10. (C) This formulation for teacher compensation will be politically difficult to sell, but at least allows the government to avoid reducing any teacher salaries below

their current level (almost inconceivable in the Honduran political climate). The flip side is that maintenance of current teacher salary levels means that the government would have no room to provide any increases for other government workers in 2004. This could mean a third year of a wage freeze for these other public sector workers, an unpalatable but probably necessary result of the current fiscal situation. Low public sector salaries are one important cause of corruption and incompetence in GOH agencies.

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The Financial Sector and the Agricultural Credits Law
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¶11. (C) In its Article IV review of Honduras, the IMF Board noted the importance of addressing the extreme fragility of the Honduran financial system. In late June 2003, the World Bank adopted an USD 11 million loan to address the weaknesses identified in the recently concluded Financial Sector review (FSAP). Comment: This push to analyze and address the deep problems in the financial sector is a GOH initiative (specifically by the current Banking and Insurance Commission President Ana Cristina de Pereira). It is a complicated task, and the difficulty of the task should not be underestimated. But, the Maduro administration is making a far more serious attempt than any previous Honduran government. End Comment.

¶12. (C) The GOH appears to have been sincerely puzzled and shocked by the controversy generated in the IMF and USG over the adoption of Decree 68-2003, which consolidated the agricultural loans, interest rate subsidies, amnesties and other measures in three previous laws adopted by Congress during 2000-2002. The government believes that the new law actually lowers the cost of its assistance to the agriculture sector substantially and limits its exposure. As previously promised, the Ministry of Finance and the Banking and Insurance Commission have developed a 32-page analysis of the four laws and their implications for government finances. During the week of June 23, this analysis was sent to the IMF along with a computer disk containing the names of all the beneficiaries. A copy of the paper, written in Spanish, is being faxed to State (WHA/CEN/Brett Makens) and Treasury; a fuller summary will be provided septel.

¶13. (C) The previous three laws, adopted starting in 2000, were motivated by a wish to help farmers and the banks to overcome the financial losses suffered during and in the aftermath of Hurricane Mitch in late 1998 and the ensuing stagnation in the sector. According to the GOH report, the measures provided interest rate subsidies for loans totaling USD 252 million, loan forgiveness of USD 39.6 million, financed by bonds, and commitments to extend these benefits to an additional USD 83 million worth of loans. The previous decrees also authorized automatic guarantees for ag loans (50-70 percent) that represented an additional contingent obligation for the government, estimated at USD 144.5 million.

¶14. (C) Decree 68-2003 was developed to consolidate the committed fiscal resources into one mechanism, in order to rationalize the credit programs, avoid additional contingent liabilities, relieve pressure on the banks with large outstanding agricultural portfolios and encourage the provision of new loans to the Honduran ag sector. Delinquency in loan repayment and other high risk factors have resulted in a rapid contraction of agricultural lending by the Honduran financial system. The GOH report notes that new agriculture loans accounted for 8.3 percent of bank lending in 1999 and only 4.1 percent in 2002.

¶15. (C) The IMF staff working on the Honduran program reacted strongly and adversely in April to the news of Decree 68-2003, terming it a new subsidy program that benefited large, politically influential landowners that would have an immediate negative impact on government finances and the IMF program under negotiation. The GOH report is an attempt to demonstrate that this program is not at all new and that the costs are actually lower than would be the case under the previous system. The beneficiaries are limited to those individuals who already were entitled under the previous three decrees. Note: A modification made by Congress in April to the bill would have made the benefits available to additional (unlimited) beneficiaries now and in the future; Econoffs heard in May from members of the Bankers' Association that this news was resulting in widespread loan payment delinquency and new requests for debt forgiveness. The government subsequently worked with the Congress to correct this issue in the final version of the law, before it was signed by the President and published. End Note.

¶16. (C) The tables below provide the government's estimates of the costs implicit in the earlier regime and the new

one. The cash cost of the various agricultural credit programs has been reduced slightly in nominal terms and significantly in present value terms.

Financial Costs of Previous Scheme

	Nominal (USD million)	Present Value (USD million)
Interest Subsidies	86	65
Interest on bonds	21	13
Transfers to BANADESA	33	19
Funding of FONGAC	28	28
Bond issue	--	17
	168	142

Financial Costs of Current Scheme

	Nominal (USD million)	Present Value (USD million)
Transfers to trust	98.0	80.0
Interest on bonds	9.6	7.4
Transfers to BANADESA	33.0	19.6
Funding of FONGAC	11.3	--
Subsidies already paid	11.0	--
	162.9	107.0

Note: The current exchange rate is 17.3 lempiras to the dollar.

¶17. (C) Why wasn't there better consultation with the IMF and USG? The GOH explanation is that they did consult, but they really didn't see it as a new program with new fiscal costs. The law was mentioned in passing by the Finance Minister to IMF Mission chief and IMF permanent rep early in the year. Banking Commission President Ana Cristina Pereira indicates she had discussed it with members of the IMF-World Bank FSAP team, but the resident director of the World Bank program is not aware of these discussions (the FSAP included a large number of small teams working on different aspects of the financial sector). President Maduro did not raise the issue during his meeting with US Treasury Secretary Snow, probably for the same reasons. In response to complaints from Washington about the lack of consultation, the GOH is now doing its best to put as much information on the table as possible.

The Implications for Debt Deferrals and Forgiveness

¶18. (C) In the meantime, Honduras' failure to reach an IMF agreement has ended the deferral of Paris Club debt service payments, once again putting overdue loan payments to the U.S. into active status. In late June, ExIm Bank took Honduras off-cover for public sector loans. The Embassy has informed the GOH that lack of payment on overdue Department of Defense Loans -- USD 12,187 in mid July 2003 and USD 1,762,150 in early September 2003 -- could trigger Brooke Amendment sanctions. Embassy also is exploring whether other overdue loans could trigger 620Q sanctions. The GOH is not at liberty to pay only one official creditor under Paris Club rules. According to the GOH's accounts, outstanding debt service owed to the USG (Department of Defense, Eximbank and AID) totals USD 17.7 million Of this amount, 8.1 million is over 6 months overdue and could trigger Brooke or 620Q sanctions.

Can the USG Help Push This to A Close?

¶19. (C) In candid conversations with the Ambassador and other USG officials, President Maduro and Minister of the Presidency Luis Cosenza (and their political advisors) have repeatedly emphasized (1) how difficult politically it would be to change the teacher and medical worker statutes and (2) how unfairly the IMF has treated the Maduro team, when the very policies that have caused the underlying fiscal problems were enacted by the two previous administrations without protest from the IMF at the time. For the last year and a half, while the macroeconomic team has conducted the difficult negotiations with the Fund, the top level of government has flailed around trying to get high-level donor pressure on the Fund to back down on some of its conditionality. Many in the donor community (including members of the EU and international financial institutions) have expressed sympathy for the position. But none of these urgent requests for flexibility have helped soften the IMF position (recently confirmed during

the Article IV consultations). In addition, some have suggested that it might be best for the GOH to request a change in the IMF mission staff so that past differences of opinion do not continue to color future negotiations. The GOH has asked the Embassy for its recommendations on this rather sensitive suggestion.

¶20. (C) Comment: There is a lot of truth to the GOH claims that the underlying macroeconomic problems (such as the statutes, the web of special tax exemptions and the ag debt forgiveness programs, to name three) were inherited from previous administrations and that the IMF perhaps should have stood stronger against these policy lapses at the time. However, the problems are real and, if left unaddressed, will continue to prevent the achievement of macroeconomic stability and growth. President Maduro needs to get control over the public sector wage bill for the good of the country, as well as for the purposes of an IMF agreement. Deep down, he knows this. In addition to the harm caused to efforts to balance the budget and invest in the country's future, the statutes put the teachers and doctors in a privileged class of public servants, to the detriment of other public workers. They must be changed at some point.

¶21. (C) And, finally, the GOH has come a long way. Post believes strongly that now is the time for the USG to give a little push. Maduro badly needs reassurance from high level USG officials that (1) the IMF-suggested civil service reforms (and the ensuing political fight) are indispensable, (2) the international community will support him if he does take this move, and (3) that an IMF agreement would likely be forthcoming quickly after passage of the law even if all IMF targets for reduction of the public sector wage bill are not completely met. Post seeks Washington agencies' input and advice on whether this is appropriate and how best to achieve it. End Comment.

Palmer